Theory and Practice of Banking
First Year Second Semester
Bachelor of Business Administration (BBA)

Chapter-4

Credit Management Policies

Credit

A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at a later date, generally with interest. It includes credit cards, mortgages, car loans, and business lines of credit.

Credit management

Credit management is the process of granting credit, setting the terms it's granted on, recovering this credit when it's due etc.

Effective credit management is a comprehensive process consisting of:

- Determining the customer's credit rating in advance
- Frequently scanning and monitoring customers for credit risks
- Maintaining customer relations
- Detecting late payments in advance
- Detecting complaints in due time
- Preventing any bad debt from arising

Loan

Loan is an arrangement in which a lender gives money to a borrower, and the borrower agrees to repay the money, usual along with interest, at some future point in time.

Features of loan

- Parties
- Time to maturity
- Loan amount
- Ultimate decision
- Mode of loan
- Nature of distribution
- Process or disbursement
- Securing
- Interest
- Periodicity
- Repayment of Loan

loan Vs. investment

Particulars	Loan	Investment
Definition	Loan is defined as to give someone money that will be repaid with interest.	An investment is an asset that will generate income in the future.
Nature	Loans are liabilities.	Investments are assets.
Contracts	Direct.	Indirect.
Period	Depends upon lender and receiver of loan.	Depends upon type of instruments.
Transaction	It is transaction of debt.	It is mostly related with securities transaction.
Parties	There are two parties i.e. lender and borrower.	There is only one party that is Investor.
Outcomes	Interest is the outcome loan.	Profit or loss is the outcome of investment.
Termination	Termination depends on borrower	Termination depends on investment policy.

Advance

Advance is a credit facility that is provided to an individual or corporation generally granted by the banks to meet short-term financial requirements.

Different types of bank advance

- **Short term loan:** The entire amount is given to the borrower at one time
- **Overdraft:** A provision by the bank, wherein the customer can overdraw money from his/ her account until a specified limit.
- **Cash credit:** A provision by the bank, wherein a customer can advance money up to an asset pledged.
- **Bill purchase:** Advances granted by the bank upon pledging the bills.

Loan Vs. Advances

Particulars	Loans	Advances
Meaning	Funds borrowed by an entity from another entity, repayable after a specific period carrying interest rate is known as Loans.	Funds provided by the bank to an entity for a specific purpose, to be repayable after a short duration is known as advances.
Nature	A loan by nature is a debt.	Advances are by nature a credit facility.
Time duration	Loans are generally for a long term.	Advances are for short term, maximum for one year only.
Legal formalities	There are legal formalities while granting a loan.	There is low legal formalities as compared to the loan.
Collateral security	A loan is may be secured against collateral security or not.	Advances are facilitated only against primary security or any type of guarantee.
Example	Auto loan, Personal loan, Education loan, Home loan etc.	Short term loan, Overdraft facility, Cash credit, Bill purchased etc.

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Types of bank loan and advance

On the basis of object or purpose:

Commercial Loans: This loan is taken, to meet short term requirement of capital e.g., working capital.

Consumer Loan: This loan is taken to finance household goods like fridge, T.V., scooter etc.

Agricultural Loan: Such a loan is taken by the farmers to meet their short term requirements like buying seeds, fertilizers, insecticides etc.

On the basis of Time

Short Term Loan: Such a loan is taken for a period of less than one year.

Medium Term Loan: Such a loan is taken for a period ranging from 1 year to 3years

Long Term Loan: Such a loan is taken to meet long-term requirements from 3 years to 20 years or more.

Types of bank loan and advance

On the basis of Security

Secured Loan: Such a loan is granted on the security of tangible assets.

Unsecured Loans: Such a loan is granted without any security.

On the basis of form

Loan: Loan is defined as to give someone money that will be repaid with interest.

Cash credit: Cash credit is an arrangement by which the customer is allowed to borrow money up to a certain limit known as the cash credit limit.

Overdraft: Overdraft is an arrangement between a banker and his customer by which allowed to withdraw over and above his credit balance in the current account up to an agreed limit.

Secured loan Vs. Unsecured loan

Particulars	Secured Loan	Unsecured loan
Meaning	The loan which is secured by an asset is known as a secured loan.	Unsecured loan is the loan in which there is no asset mortgaged as security.
Guarantee	In a secured loan there is a guarantee.	There is no guarantee In the case of an unsecured loan
Basis	Collateral.	Creditworthiness.
Pledging of asset	Pledging of asset is required.	Pledging of asset is not required.
Risk of Loss	Risk of Loss is less.	Risk of Loss high.
Period	Long period	Short period
Expensive	No, due to low interest rates	Yes, because the interest rate is high.
Borrowing limit	Borrowing limit is high.	Borrowing limit is comparatively less.
Right of lender in case borrower fails to pay.	Forfeit the asset.	Can sue him for the money.

Cash credit Vs. Overdraft

Points	Cash Credit	Overdraft
Definition	An arrangement where the customer borrow money up to a certain limit.	A loan in which the account is allowed to go into debit usually up to a specified amount.
Duration	Though it is a short term loan Sometimes it is provided for mid-term of periods.	Overdraft is always provided for a short term period.
Guarantee	Cash credit is provided against pledge of hypothecation of goods.	This is granted against securities.
User	Cash credit is allowed to the businessman.	Overdraft is allowed to the current account holders of the bank.
Repayment	The loan may be repaid in instalments or at the expiry of certain period.	The borrower is permitted to repay any number of times.
Purpose	For increase the current capital.	For meet the cash demand.

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Bank’s demand deposit

Bank’s demand deposit means the funds kept by the bank to meet consumers need for daily expenses. This can be withdrawn at any time from the bank to meet their daily expenditure.

Credit analysis

Credit analysis is the process of determining the ability of a company or person to repay their debt obligations.

Approaches of credit analysis

Traditional approach: The traditional approach evaluates the main characteristics of the borrower, commonly referred to as the 5 C’s of Credit.

Modern approach: Modern credit analysis approaches are based on qualitative credit scoring systems. The key aspects of a borrower that determine their credit score include payment history, current debt, length of debt, type of debt, and the payment interest.

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Credit worthiness

The five Cs of credit is a system used by lenders to gauge the creditworthiness of potential borrowers.

- Capacity: Capacity to repay is the most critical of the five factors. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan.

Capacity means the probability of successful repayment of the loan by the borrower.

- Capital: Capital is the money you personally have invested in the business and is an indication of how much you have at risk should the business fail.
- Collateral: Collateral or guarantees, are additional forms of security ensured by the lender when granting loan.
- Conditions: Conditions describe the intended purpose of the loan. The lender will also consider local economic conditions and the overall climate, both within your industry and in other industries that could affect your business.
- Character: The lender will form a subjective opinion as to whether or not you are sufficiently trustworthy to repay the loan or generate a return on funds invested in your company.

Loan structure

Loan structuring is the way in which the loan product is set up to accommodate the borrower’s best interest, either in short, medium or longer terms depending on the client’s end goal.

Loan can be structured based on the following categories

Based on Security

1. Secured Loan

2. Unsecured Loan

Based on Repayment

1. Time Loan

2. Instalment Loan

3. Demand Loan

The basis of the purpose of such loans can be

1. Car Loan
2. Home Loan
3. Education Loan
4. Commercial Loan
5. Personal Loan

Documents required to avail a loan

Personal Loan Documents Required Checklist	
Photo Identity Proof (any one)	Voter ID Card / Passport / Driving License.
Residence Address Proof (any one)	Ration Card / Passport / Utility Bill.
Income Proof	Last 3 months Payslip & Bank Statement of last 3 months.
Job Continuity Proof	Job Offer Letter / Letter from the HRD (if current employment less than 2 years).
Financial Documents	a. Salaried Individuals: Latest 3 month's Salary Slips and Form 16, Bank Statements of 6 months. b. Self Employed Individuals: Latest 1 year bank statement for both savings and current account.
Photo	1 passport size colour photograph
Application Form	Personal Loan Application Form duly filled.

Characteristics of security

- Marketability
- Easy ascertainment of value
- Stability of price
- Easy storability
- Durability
- Transportability
- Cost consideration
- Ownership
- Documentation
- Financial Ability

Security

Security is a tradable financial asset use to guaranty the repayment of a loan. It may include tangible, intangible assets or even personal guarantee.

Different types of securities

Pledge

Mortgage

Hypothecation

Assignment

Mortgage

Mortgage is a legal agreement that conveys the conditional right of ownership on an asset or property (**immovable property**) by its owner (the mortgagor) to a lender (the mortgagee) as security for a loan.

Problem loan

A loan that the borrower cannot or is unwilling to repay according to the original loan agreement.

A loan that is at least 90 days past due or a consumer loan that is at least 180 days past due.

This type of loan is also referred to as a nonperforming loan, troubled loan, sour loan.

Indications of problem loan

Quantitative Indicators

- Preparation of irregular and delayed financial statements
- Creating hindrances to the main source of income
- Diminishing deposit balance
- Non-repayment of the loan instalments as repayment dates.
- Continuous decline in the market price of the shares of the borrowing company.
- Excessive cash dividend pay outs from reserve fund or even from capital.
- At the end of the cycle, creditors are not completely paid out.

Qualitative Indicators

- Sudden death or accident of chief executive of the business
- Avoiding communication with the lending bank.
- The borrowing organization is not operating smoothly due to some conflicts among the executives and among the board members.
- Bitter relationship between borrower and lending bank.
- Financial control mechanisms are weak.

Distress loan

A distressed loan is a loan when a borrower is unable to fully repay their debt on time, due to financial difficulties. A **distressed** borrower can be either a person or a business whose income falls due to unforeseen circumstances.

Bank’s response to distressed/Problem loan

Usual procedure: The usual loan recovery procedure is divided into several steps.

Issue of demand notice	Legal notice	Special notice	Field recovery	Personal Communication	Loan Recovery Camp	Interest exemption

Legal procedure: Collection of debt by the law is called legal procedure.

Sources of credit information

Internal sources

Application

Interview

statement

Bank's own record

External sources

Government or regulatory authorities

- Income tax office
- Government gazette
- Records from the other govt. office
- Registrar of joint stock companies

Other sources

- Inspection
- Market report
- Credit information bureau
- Newspaper

Loan pricing

Loan pricing is the process of determining the interest rate for granting a loan, typically as an interest spread (margin) over the base rate.

The ways to price of loan

Interest expense

Administrative cost

Cost of capital

Price of the loan (Interest Rate Charge) = Base Rate + Risk Premium.

The loan classification as per regulatory requirements

All loans and advances will be grouped into four categories

- Continuous Loan
- Demand Loan
- Fixed Term Loan
- Short-term Agricultural & Micro Credit.

Sound landing policy

Sound lending policy refers the lending philosophy standards and guidelines for granting a loan that its employees must observe in granting or refusing a loan.

Principles of sound lending policy

- Safety
- Liquidity
- Profitability
- Security
- Purpose or the loan
- Sources of Repayment
- Diversification of risk

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